FRB – Debit Card Interchange Fees and Routing
Executive Summary

On November 14, 2023, the Federal Reserve Bank (FRB) issued a proposal to drastically change the debit interchange cap. Importantly, the proposal also includes a formula that would periodically adjust the interchange fee cap based on data voluntarily reported to the FRB by debit card issuers. If adopted, this formulaic approach would result in automatic revisions to the amount of the interchange fee cap every two years, without any public comment.

I. Background

- **General Overview**

In 2011 and 2012, the FRB introduced standards for debit card interchange fees, as mandated by Congress. This was implemented through Regulation II, also known as the Durbin Amendment. The regulation requires the FRB to set criteria for determining whether the interchange fee received by a debit card issuer is "reasonable and proportional" to the issuer's costs related to the debit card transaction. It also allows for adjustments to account for fraud prevention expenses.

Under the current rule, debit card issuers can charge interchange fees for transactions that do not qualify for statutory exemptions. These fees consist of a base component of 21 cents, an ad valorem component of 5 basis points multiplied by the transaction value, and a fraud-prevention adjustment of 1 cent per transaction for issuers meeting specific fraud-prevention standards.

Regulation II primarily applies to financial institutions, including credit unions, with assets exceeding $10 billion, and imposes specific rules and restrictions on interchange fees, network exclusivity, and routing options for debit card transactions. However, smaller financial institutions, including credit unions, with assets below $10 billion, government-administered payment programs, and prepaid card issuers are exempt from these provisions, allowing them greater flexibility in managing debit card operations. The overarching goal of Regulation II is to foster competition, fairness, and transparency in the debit card market, ultimately benefiting consumers and businesses by creating a more competitive payment landscape.

- **Biennial Report**

By way of background, the FRB has collected data from covered issuers regarding the costs incurred in connection with debit card transactions during the calendar years 2011, 2013, 2015, 2017, 2019, and 2021. The FRB has reviewed the interchange fee standards outlined in Regulation II (§235.3) by considering the most recent data collected in 2021, along with the cumulative data obtained from covered issuers since the initial Regulation II rulemaking.

The 2021 biennial report provides data from covered card issuers, revealing that payment card networks in the United States processed 92.1 billion debit and general-use prepaid card transactions with a total value of $4.3 trillion. Notably, card-not-present transactions increased to 32.1%. The FRB's analysis indicates that the interchange fees charged remained higher than the actual costs incurred by issuers. Among covered issuers, the average authorization, clearing, and settlement costs per transaction, excluding issuer fraud losses, were $0.039 in 2021, the same as in 2019. The report also highlights that merchant absorbed 47% of fraud losses, issuers absorbed 33.5% of fraud losses, and the remaining portion was absorbed by cardholders, with prepaid cards experiencing the most significant increase in fraud. Moreover, according to the FRB, the current report indicates that transaction-processing costs of the average debit card transaction declined by nearly 50%, from 7.7 cents in 2009 to 3.9 cents in 2021 with declines in fraud losses over the same period.

II. Summary of Proposed Rule

A. Proposed Revisions to the Interchange Fee Standards (§235.3) and Fraud Prevention Adjustment (§235.4)

- **Key Revisions to Debit Interchange Fee Caps**

In summary, the proposal would adjust debit interchange fee caps as follows:

Type of Rate Component	Current Rate	Proposed Rate	Difference
Base Component/Fee Cap	21 cents	14.4 cents	-6.6 cents
Ad Valorem Component	5.0 basis points	4.0 basis points	-1.0 basis points
Fraud-Prevention Adjustment	1 cent	1.3 cents	+0.3 cents

Furthermore, the proposed changes would codify in Regulation II an approach for updating the three above components of the interchange fee cap every other year, commencing in 2025. These updates would be based on the most recent data reported to the FRB by covered issuers. Historically, the FRB has published data two years after its collection, as seen in the 2023 report, which covered 2021 data, and the 2021 report, which covered 2019 data.

Under the proposed rule, any adjustments to the interchange fee cap would be made public without soliciting public comment, with publication scheduled for odd-numbered years by March 31. These updated amounts would then come into effect on July 1 and remain valid for two years. In addition, as part of this biannual update, the proposal would not accept public comments regarding the allowed costs considered by the FRB when establishing the interchange fee standard.

According to the FRB, this approach is aimed at ensuring that the interchange fee subject to the cap remains reasonable and proportional to the issuer's transaction-related costs, in line with the requirements of the Durbin Amendment.

- **Proposed Formulas**

Proposed formulas for the biannual update of the interchange fee components:

Type of Component	Proposed Formula
Base Component	The **new** formula to calculate the base component would be the product of the transaction-weighted average of per-transaction transaction processing costs across covered issuers and a fixed multiplier of 3.7, rounded to the nearest tenth of one cent (3.9 cents * 3.7=14.4 cents).
Ad Valorem	The formula (same as used in 2011) to calculate the *ad valorem* component would be the median ratio of issuer fraud losses to transaction value among covered issuers, rounded to the nearest quarter of one basis point.

Fraud-Prevention Adjustment	The **new** fraud-prevention adjustment would be the median per-transaction fraud-prevention costs among covered issuers, rounded to the nearest tenth of one cent.

B. Other Revisions of the Proposed Rule

In addition to the proposed revisions to the interchange fee standards in § 235.3 and the fraud-prevention adjustment in § 235.4, the FRB proposes a set of technical revisions to Regulation II. In general, these proposed revisions are intended to make Regulation II clearer. Such technical changes would include the proposal adds "**covered issuer**" as a defined term in § 235.2. Under the proposal, "**covered issuer**" would mean, for a particular calendar year, an issuer that, together with its affiliates, has assets of $10 billion or more as of the end of the preceding calendar year.

III. Comment Deadline

- **February 12, 2024**.

IV. Resources

- **88 FR 78100; 11/14/2023**
- **2021 Interchange Fee Revenue Report**

V. Other Considerations

- **CUNA and AACUL Study**

While the proposal exempts financial institutions with less than $10 billion in assets, Credit Union Nation Association (CUNA) and American Association of Credit Union Leagues (AACUL) **released a study** that shows mandated interchange caps negatively impact local and community financial institutions like credit unions.

- **Questions to Consider**

a. Is the proposed two-year cadence for updating the cap appropriate, or should the FRB determine these amounts more or less frequently?
b. Is the proposed fixed multiplier (3.7) appropriate or should the FRB select an alternative cost-recovery target? If so, why?
c. Should the FRB adopt an alternative methodology for determining the *ad valorem* component? If so, why?
    - *Note: The proposed is the median ratio of issuer fraud losses to transaction value among covered issuers, multiplied by the value of the transaction.*
d. Should the FRB adopt an alternative methodology for determining the fraud-prevention adjustment? If so, why?
    - *Note: The proposed is the median per-transaction fraud-prevention costs among covered issuers.*
e. Do the rounding conventions for the cap components provide an appropriate degree of precision? If not, what alternative rounding conventions should the FRB adopt?
    - *Note: The proposed is as follows: base component (nearest tenth of one cent); ad valorem (nearest quarter of one basis point); fraud prevention adjustment (nearest tenth of one cent).*

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